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January 18, 2005

Hon. Pat Miller, Chairman
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, Tennessee 37243

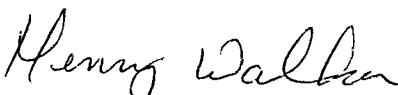
Re: *Petition of Tennessee American Water Company to Change and Increase
Certain Rates and Charges*
Docket No. 04-00288

Dear Chairman Miller:

Enclosed please find the original and fourteen (14) copies of the Rebuttal Testimony of Michael Gorman submitted on behalf of the Chattanooga Manufacturers Association.

Very truly yours,

BOULT, CUMMINGS, CONNERS & BERRY, PLC

By: 
Henry Walker *KG*

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**Before the
Tennessee Regulatory Authority
Docket No. 04-00288**

TENNESSEE-AMERICAN WATER COMPANY

Rebuttal Testimony and Exhibit of

Michael Gorman

On behalf of

Chattanooga Manufacturers Association

Project 8303
January 2005



BRUBAKER & ASSOCIATES, INC.
ST. LOUIS, MO 63141-2000

**Before the
Tennessee Regulatory Authority
Docket No. 04-00288**

TENNESSEE-AMERICAN WATER COMPANY

Rebuttal Testimony of Michael Gorman

1 **Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

2 A My name is Michael Gorman My business address is 1215 Fern Ridge Parkway,
3 Suite 208, St Louis, MO 63141-2000

4 **Q ARE YOU THE SAME MICHAEL GORMAN THAT HAS PREVIOUSLY PROVIDED**
5 **TESTIMONY IN THIS PROCEEDING?**

6 A Yes

7 **Q WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY IN THIS**
8 **PROCEEDING?**

9 A I will comment on certain aspects of the Consumers Advocate and Protection Division
10 (CAPD) testimony in this proceeding Specifically, I will comment on CAPD's
11 proposal to (1) reduce rates by lowering the Company's revenue requirement by
12 \$1 5 million from the present level, and (2) recover the reallocation of public fire
13 protection cost among customers based on a property valuation allocator

1 Q WHAT IS THE CAPD'S PROPOSED REVENUE REQUIREMENT AND CHANGE IN
2 RATES FOR TAWC IN THIS PROCEEDING?

3 A In the direct testimony of CAPD witness Terry Buckner, he recommends that the
4 Company's revenue entitlement be reduced by \$1 53 million and that rates be
5 reduced accordingly

6 Q IS THE CAPD'S REVENUE REQUIREMENT POSITION STARKLY DIFFERENT
7 FROM THAT OF THE COMPANY?

8 A Yes The Company is seeking permission to increase its revenue requirements by
9 \$1 9 million

10 Q ARE YOU SURPRISED THAT THERE IS SUCH A SIGNIFICANT DIFFERENCE
11 BETWEEN THE CAPD REVENUE REQUIREMENT POSITION AND THAT OF THE
12 COMPANY?

13 A No In fact, in recent months there appears to be a pattern of American Water Works
14 Company affiliates requesting substantially higher revenue requirements than those
15 ultimately found reasonable by regulatory commissions. TAWC's recommendations
16 here appeals to a continuation of that trend.

17 Q PLEASE SUMMARIZE THE RECENT AMERICAN WATER WORKS COMPANY
18 AFFILIATE RATE FILINGS YOU ARE REFERENCING.

19 A As shown on my Exhibit MPG-2, Schedule 1, American Water Works Company
20 affiliates around the country have received a small fraction of the revenue
21 requirement increase they requested from regulatory commissions. For example, in
22 Missouri, the Missouri-American Water Company initially sought an increase of

1 \$20 million. However, it ultimately accepted a settlement position where its revenues
2 were not increased. In Indiana, the Indiana-American Water Company sought an
3 increase of 14% or nearly \$20 million, but the Indiana Commission awarded it a 0.4%
4 increase, approximately \$560,000. Similarly, in West Virginia, the West Virginia-
5 American Water Works Company sought an increase of \$15.6 million, but was
6 awarded an increase of only \$1.8 million.

7 As shown on my Schedule 1, the 2004 rate award of eight American Water
8 Works Company affiliates produces less than one-third of the revenue requirement
9 increase the water utilities requested.

10 **Q WHY DO YOU BELIEVE THAT THE AMERICAN WATER WORKS COMPANY**
11 **AFFILIATES ARE REQUESTING REVENUE REQUIREMENTS SO FAR OUT OF**
12 **LINE WITH WHAT REGULATORY COMMISSIONS FIND TO BE APPROPRIATE?**

13 **A RWE acquired American Water Works Company via the acquisition of Thames in**
14 **calendar year 2003. RWE has stated an intention to increase the return on all of its**
15 **affiliates including the utility assets at American Water Works Company. At Page 68**
16 **of RWE's 2003 Annual Report to Shareholders, it states:**

17 American Water will grow its operating results primarily through its
18 on-going rate increases and improved efficiency (emphasis added)

19 Accordingly, American Water Works Company has been directed by RWE to enhance
20 its rate of return in order to meet RWE's objectives of increasing its operating
21 affiliates' returns.

22 Importantly, due to acquisition costs, RWE's investment in American Water
23 Works Company is likely to be greater than American Water Works Company's
24 affiliates' book value investments in water utility assets. This pattern suggests that the

1 water utility affiliates are pushing for higher rates to maximize book value returns to
2 meet RWE's return objectives

3 **Public Fire Protection (PFP) Cost Allocation**

4 **Q WHAT IS THE CAPD'S PROPOSAL FOR RECOVERING THE COST OF PUBLIC**
5 **FIRE PROTECTION THAT WAS PREVIOUSLY PAID BY THE CITY OF**
6 **CHATTANOOGA?**

7 A CAPD's position is not clear. However, CAPD witness, Dr. Steven Brown, states at
8 page 11 of his testimony that, in his opinion, if the PFP costs are allocated among
9 existing customers, then the use of property value is a fair method to allocate PFP
10 costs. In support for this position, Dr. Brown states that when the City was paying for
11 public fire protection, it was relying on its revenues from property taxes to fund this
12 operating cost. He implies that the City of Chattanooga's only revenue source is
13 property taxes, which are levied in proportion to the assessed property value.

14 **Q DO YOU BELIEVE THE CAPD'S POSITION ON REALLOCATION OF PUBLIC**
15 **FIRE PROTECTION COSTS SHOULD BE ADOPTED?**

16 A No. CAPD's recommendation for the recovery of public fire protection cost is
17 erroneous and unreasonable for many reasons. First, the City of Chattanooga
18 collects revenue from many sources, and not simply from property taxes alone. The
19 City's 2005 projected operating budget disclosed that only 61% of its revenues will be
20 derived from property taxes. Thus, the CAPD's proposed PFP allocation based on
21 property taxes does not accurately reflect how the City of Chattanooga collects
22 revenues to meet its operating expenses.

1 Second, CAPD's position is erroneous because it assumes that TAWC's
2 property tax bill will go down because the City of Chattanooga will no longer be
3 paying public fire protection costs. This is simply not an accurate conclusion.
4 Indeed, the City's taxpayers, including TAWC, will continue to pay property taxes to
5 the City in 2005. Indeed, the City's property assessments increased in 2003.¹ In
6 addition, water customers, who are also by and large City taxpayers, will also pay
7 rates to TAWC to recover PFP costs. Hence, there is not a correlation between PFP
8 cost and property taxes.

9 Third, CAPD's proposed allocation is punitive and unfair to customers that
10 invest in private fire protection systems. Industrial customers who install private fire
11 protection systems will enhance their property valuations, and simultaneously reduce
12 their reliance on the public fire protection service provided by TAWC. However,
13 CAPD's proposed recovery method will place a disproportionately high burden on
14 precisely those customers that have reduced their reliance on the public protection
15 system. For this reason, the CAPD's proposed cost allocation is flawed and
16 unreasonable.

17 Finally, CAPD's proposed allocation of public fire protection costs does not
18 refer to reasonable, widely accepted water utility cost allocation principles. Therefore,
19 CAPD's position must be rejected as inappropriate because it is not based on
20 accepted allocation principles.

¹City of Chattanooga Comprehensive Annual Financial Report for the year ended June 30, 2003 at Page ix

1 **Q WHY DO YOU BELIEVE THAT THE CAPD'S PROPOSED ALLOCATION OF**
2 **PUBLIC FIRE PROTECTION COSTS IS NOT BASED ON ACCEPTED WATER**
3 **UTILITY COST ALLOCATION PRINCIPLES?**

4 A The American Water Works Association publishes a cost allocation manual that is
5 largely followed by water utilities, including TAWC and its affiliates, regulatory
6 Commission Staff experts, and other rate experts around the country ²

7 The manual correctly observes that the provision of public fire protection
8 service causes water utilities to incur greater costs of production in the form of fire
9 hydrants, larger pumps and larger diameter mains in order to supply the volume of
10 water instantaneously needed to fight fires. In the event these costs are not
11 recovered directly from municipalities, the manual recommends that these costs be
12 allocated using the standard base extra capacity method. Hence, these costs would
13 be spread over customers in a manner very similar to the cost study relied upon by
14 TAWC in its last rate filing Very often, in the absence of a specific, separate hydrant
15 charge, the costs identified with providing PFP are recovered in proportion to class
16 revenues from rates for general water service

17 **Q IS THE ALLOCATION OF PFP COSTS YOU ARE ADVOCATING CONSISTENT**
18 **WITH THE AWWA MANUAL?**

19 A The AWWA manual advocates the use of sound cost allocation methodology to
20 properly assign water utilities' costs between appropriate functions and then allocate
21 those costs amongst customers TAWC performed a cost of service study that would
22 meet these sound cost of service objectives in its last rate proceeding. Accordingly,
23 the most appropriate means of allocating public fire hydrant costs is by development

²*Principles of Water Rates, Fees, and Charges*, Manual M1, Fifth Edition, 2000

1 of a complete, accurate and reasonable cost of service allocation model Absent
2 such a model, I believe that spreading the PFP costs over total revenues is the best
3 proxy for how those costs would have been spread using a complete and reasonable
4 cost of service model Therefore, I am not taking issue with the Company's proposal
5 in this proceeding to reallocate PFP costs using total revenues

6 **Q DOES THIS COMPLETE YOUR REBUTTAL TESTIMONY?**

7 **A** Yes, it does

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TENNESSEE-AMERICAN WATER COMPANY
SUMMARY OF AMERICAN WATER COMPANY AFFILIATE RATE FILINGS
(2004 RATE ORDERS)

<u>Line</u>	<u>Affiliate</u>	<u>Jurisdiction</u>	<u>Docket No.</u>	<u>Requested Increase</u>	<u>Percent Increase</u>	<u>Final Order Increase</u>	<u>Percent Increase</u>	<u>Final Order Date</u>
1	Missouri-American Water ⁽¹⁾	MO	WR-2003-0500	\$ 20,000,000	12 2%	\$ -	0 0%	Apr-04
2	Indiana-American Water	IN	42520	\$ 19,400,000	14 3%	\$ 564,801	0 4%	Nov-04
3	West Virginia-American Water	WV	03-0353-W-42T	\$ 15,550,687	16 4%	\$ 1,828,000	1 9%	Jan-04
4	New Jersey-American Water	NJ	WR 03070511	\$ 51,908,023	20 6%	\$ 24,147,323	9 6%	Feb-04
5	Pennsylvania-American Water	PA	R-00038304	\$ 64,946,533	18 2%	\$ 34,314,150	9 5%	Jan-04
6	Virginia-American Water	VA	PUE-2003-00539	\$ 2,500,000	8 4%	\$ 928,835	3 8%	Sep-04
7	Hawaii-American Water	HI	20966	\$ 767,530	10 8%	\$ 245,813	3 5%	May-04
8	Tennessee-American Water	TN	03-00118	\$ 3,866,813	13 4%	\$ 2,745,411	9 5%	Jun-04
9	Average 2004			\$ 22,367,448	14 3%	\$ 8,096,792	4 8%	

Notes

⁽¹⁾ In the Final Order the Missouri Public Service Commission authorized a decrease in rates of \$350,000 in the Joplin District All other Districts saw rates remain the same

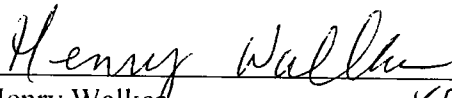
CERTIFICATE OF SERVICE

I hereby certify that I have on this 18th day of January, 2005, served the foregoing pleading either by fax, overnight delivery service or first class mail, postage prepaid, to all parties of record at their addresses shown below.

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